AF4 2023/2024
Practical Issues
Part 3 Asset Allocation

Having chosen a strategy the last part is to select the make up of the recommended portfolio. An investor's portfolio is made up of different asset classes and securities. It can use exclusively collective investments, exclusively directly held investments or a mixture of both. To make things simpler we'll assume that we are only going to use collective investments.

The milestones for this part are to understand:

- The key indicators for assessing the appropriateness of a portfolio
- How Modern Portfolio Theory can be applied to portfolio construction.
- The difference between a "Top Down" and "Bottom up" strategy
- The principles of benchmarking

In assessing whether a portfolio is appropriate it should:

- Be appropriate for the client's aims and objectives.
- Be diversified through different asset classes, geographical location and industry sectors.
- Use tax efficient wrappers as far as possible.
- Not expose the client to a greater risk than they would be prepared to accept.

Before advising a client to invest in non-cash assets the adviser should check:

- The client has sufficient cash savings to cope with emergency needs (typically 6 months net income) and any planned spending over the next 6 months
- That any short term high interest debts such as credit cards are paid off first

Following **Modern Portfolio Theory**, the order in which a portfolio should be constructed is:

- Decide on the asset allocation of the whole portfolio.
- For each class decide the geographical split, For example the share component could be split into 40% UK, 30% US, 20% Europe, 10% Japan
- Then for each one of these split into sectors, e,g, technology, Banks, Retail
- Finally individual stocks are selected.

This is also known as **Top Down** Allocation. The opposite is **Bottom Up** which start with individual shares and is usually found in specialist funds.

Most individuals will be recommended to use collective investments. These offer greater diversification but selection of securities and when these should be sold will be done by the manager or by an algorithm in the case of a tracker fund. The individual and the adviser have no say in that decision. This means in a top-down approach advice can only be given on the first two parts and possibly the third if specialist funds are used.

The adviser and client will work on an **advisory basis,** that is the advisor makes a recommendation but the client must consent to this. If a fund was performing poorly and the client was recommended to switch this cannot go ahead unless the client agrees.

To be appropriate the portfolio should have an adequate level of diversification.

The 60/40 rule

This is one of these rules that has been an article of faith amongst analysts and advisers.

It states that a portfolio split 60% in higher risk investments such as shares and 40% in lower risk assets such as Bonds should deliver a positive return in most trading periods. It relies on the fact that equities and bonds are usually negatively correlated. If equities prices are rising then bond prices should be falling Shares will provide the growth but bonds should help smooth out the performance.

In the last 10 years as a result of Quantitative Easing and low interest rates, both equities and bonds rose in value but during 2022 both equity and bond prices fell. In appraising investments or a portfolio it is unfair to look at single years in isolation but the 60/40 rule could be under threat unless shares and bonds return to being negatively correlated.

The choice of the equity portion should also be negatively correlated. If using funds then these should be spread across growth and value funds together with funds investing in different geographical areas.

Advisers do not need to slavishly follow the 60/40 model. If the client has a lower risk appetite then a 50/50 split might be more appropriate Conversely someone with a higher risk approach might prefer an 80/20 split.

Whatever split is chosen it is important that consideration is given to rebalancing this at the annual review. For example if £100,000 was invested using a 60/40 split then the initial investment would be £60,000 in equities and £40,000 in bonds. After 12 months the equities have risen to £70,000 and the Bonds fell to £35,000 the split would be 66/34. This should be reviewed with the customer to see whether some of the equities should sold and used to invest more in bonds to bring the split back to 60/40.

Tax efficiency.

The first port of call should be to use the client's ISA allowance to make income and gains tax free. Whilst this is capped at £20,000 per tax year consideration should be given to

transferring non-ISA assets into an ISA wrapper each tax year. This would be a disposal for CGT purposes so care should be taken not to exceed the individuals CGT exemption.

Pensions are also an efficient tax wrapper and have the same tax breaks as an ISA plus tax relief on the original investment. Any contribution must be within the individual's annual allowance and the investment cannot be accessed until the investor is 55.

An Investment/insurance bond might offer another possibility although some platforms will not accept these. The investor is only liable for income tax when there is a chargeable event so there is more control over when tax needs to be paid.

For those with a higher risk appetite an EIS, SEIS or VCT could be considered

No matter what is the client's ATR and CFL, the portfolio should be structured so the range of funds have different levels of risk.

The portfolio should also have an appropriate benchmark.

Benchmarking

The next part will cover performance evaluation. There are different methods to do this but to assess relative performance it must be measured against something. An annual return of minus 5% might look bad but it could be a better performance than other comparable investments.

An individual fund and its manager can be assessed against an index which must be relevant to the fund. The performance of an equity fund should not be compared to a gilt and bond one. This also raises the issue of when fund performance is being benchmarked against an index, will the manager simply invest in securities that drive the index and effectively become a tracker fund but without the lower charges?

Indices have several limitations:

- Market weighted indices will be dominated by a small number of large companies
- They reflect changes in capital value and don't take into account dividend income
- They do take into effect the costs of buying and selling.

The second point is very significant since over the longer term the total return on a FTSE 100 tracker fund where dividends are reinvested should be considerably higher than simply the growth as measured by the index.

Another method of assessing relative performance is by making **peer comparisons**. In other words, how have you done against the other guy?

There are some practical issues with assessing this.

- Care must be taken that we are comparing like with like. It is not useful to compare

the performance of a growth to an income fund.

- The amount of new cash being made available will also make a difference in that it gives the manager new investment opportunities and may perform better than a fund which is relatively dormant in terms of cash inflows. If a fund is having cash withdrawals that will increase difficulties for the manager as it will become a forced seller of shares.
- Small funds will also be easier to run than large ones.
- The basic performance measure may not take the volatility of the fund into account.
- Consistency of performance will also be a key comparison that a crude league table will not take into account

Assessing portfolio performance is more difficult and this will be dealt with in more detail in the next part.

That concludes this part so you should now understand

- The key indicators for assessing the appropriateness of a portfolio
- How Modern Portfolio Theory can be applied to portfolio construction.
- The difference between a “Top Down” and “Bottom up” strategy
- The principles of benchmarking

Of course probably the thing a client wants to know is how well the portfolio has performed and this ill be looked at in the next section.